The Stan Clark Financial Team's

PERSPECTIVES

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Investing

# Active vs. passive investing? How about the best of both!

*By Michael Chu, Investment Advisor*

**Investing in stocks can be categorized into two main approaches: *active* and *passive*. Let's start by looking at the active approach.**

Active fund managers pick individual stocks that they think will do better than others. There are many different ways of picking individual stocks. Some managers will analyze the company, interview management and even talk to customers and competitors. They may also review historical trends and try to make forecasts on how the business will fare in the future. Investing actively seems to make a lot of sense, which explains why it is the most common method of investing. It's also appealing because people like to hear "feel-good" stories about their decisions.

But what about the actual track record of active fund managers? We can refer to the *SPIVA Canada Scorecard*[i], which reports the performance of actively managed mutual funds in Canada. The *Scorecard* also corrects for survivorship bias, which means including funds that have been closed, most likely due to bad performance. Over three-, five- and 10-year periods, the majority of Canadian mutual funds did not outperform their benchmarks. Specifically, over 10-year periods, only 9% of Canadian equity funds and only 2% of U.S. equity funds outperformed. In other words, more than 90% of funds underperformed. The amount of underperformance is notable, too. Over 10-year periods, Canadian equity funds underperformed on average by more than 1% per year, while U.S. equity funds underperformed more than 3%. Shocked? Yet it's all too true. The long-term underperformance of funds has been around for a long time.

It is important to note that, there have been shorter periods, say fewer than five years, where active funds have done better than their benchmarks. But these periods haven't lasted, and they've always been followed by periods of underperformance.

So, traditional active management doesn't work well – but not because these managers haven't been doing their homework. Rather, it's because human decision-making is systematically flawed and unreliable. Biases and emotions make it difficult to be objective. Through the teachings of behavioral finance, we know that people are often ruled by greed, hope and fear. This awareness provides us with an opportunity to use a rational, disciplined method to invest. In a sense, we are taking advantage of the flaws in human nature.

The realization that traditional active management doesn't work well has led to continued growth in the passive approach to investing. Passive investors will just buy an entire index or basket of companies that represents the market. Their objective is to match the market, not outperform it. These investors are willing to give up their chance at outperforming for the guarantee that they will not *under*perform. This strategy might seem appealing – it's simple and low-cost and will probably outperform most traditional money managers.

But passive investing has its drawbacks, as well. Buying an index means buying almost all of the stocks in a certain market. For example, the Canadian TSX Index is made up of the biggest companies that trade in Canada; about 250 of them. Even if a stock is clearly overpriced, the index must hold it. And the way most indexes are designed, the more overpriced a stock becomes, the more the index will own of it. Despite this flaw, indexes still tend to outperform most mutual fund managers. This is because of the pre-defined, set criteria that indexes use to "choose" stocks. Even if the criteria is not that good, they help indexes avoid the human emotional mistakes made by most traditional active managers.

So, what's the best approach to investing? Suppose you created your own "index" – using set criteria that made sense and helped avoid the most expensive companies. We've talked about some of these criteria before: price-to-earnings ratios, price-to-book ratios, dividends and momentum. Why not take the best of both worlds? Create a systematic approach to investing, essentially a hybrid of passive and active investing that is automatic. If a stock meets the criteria, then it's purchased. If it doesn't, then it's sold. This is similar to how the passive TSX index will mechanically add or drop a company based on predetermined rules.

Does all this seem familiar? It should, because it's exactly what we do. Essentially, with our rules-based approach, you are "indexing" your portfolio to be a specific, time-tested investment strategy. By doing so, you are combining the best qualities of passive and active investing.

Keep in mind that disciplined implementation is the key to success. It's not just *having* a good strategy – but also carrying it out. ■

[i] *https://us.spindices.com/documents/spiva/spiva-canada-mid-year-2017.pdf*

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